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JAPAN'S YEAR OF ECONOMIC DISCONTENT: WHAT HAS CHANGED?

SUMMARY

During the past year or so American commentators have noticed that the Japanese economy seems to be sputtering uncharacteristically. While Japan's economic growth in 1991 substantially exceeded that of the United States, an increasing number of analysts, particularly in this country, are beginning to ask whether the Japanese economy has undergone fundamental changes that might derail it from extending its 40-year run as one of the world's most robust industrialized economies. Those making this argument cite the remarkable plunge of the Tokyo stock market, which began in early 1990 and continues today, as important evidence for their case.

Many Japanese analysts appear far more sanguine about the prospects for the economy. Although they agree with foreign analysts that countermeasures are required, they differ among themselves as to the appropriate combination of policies. Key to the different approaches is deciding whether the economy's current difficulties foretell a prolonged period of slower growth or, alternatively, whether the current slump is essentially similar to previous postwar downturns in Japan, which have proved modest by industrial country standards. Depending on the answer, the fiscal policy proposals now on the table may be either too little to reignite growth or too large considering the economy's reduced potential growth rate. Whatever balance Tokyo strikes will have to take into account potential economic growth in the 1990s, which no doubt will fall far below the average 5 percent inflation-adjusted rate recorded annually between 1986 and 1991.

Descent from the Stratosphere: An Overview

Some data suggest that the Japanese economy, which recorded the highest rate of inflation-adjusted growth in 1990 and 1991 — 5.2 percent and 4.4 percent, respectively — among major industrialized nations, rather suddenly has become a basket case. That would appear to be one

conclusion to be drawn from the remarkable two-year fall of the Nikkei average of 225 stocks on the Tokyo Stock Exchange; by late July it had dropped 60 percent from its all-time peak, with no bottom in sight. While the stock market is critical as a barometer of business sentiment, it does not directly measure business activity. Indicators of current economic conditions, however, are almost as depressing as TSE data.

Those experts making the case that Japan's economy is in a very difficult situation point to such statistics as the monthly index of coincident indicators, an Economic Planning Agency measure designed to show the current state of the economy. The figure for May, the latest month for which data are available, revealed weakness in the economy for the 15th straight month — only one month less than during the 1973-75 downturn, the most severe of the postwar period. By contrast, the measure recorded 16 straight months of economic expansion between January 1987 and April 1988 before experiencing a one-month stall and then reviving in June 1988 to expand in 25 of the 29 months through October 1990. (The index moved inconclusively between November 1990 and February 1991.)

Pessimists regarding the Japanese economy draw many parallels with the U.S. economy, which contracted 1.2 percent in 1991 as measured by real gross domestic product. They note that both nations have many weakened financial institutions, contain a large group of apprehensive consumers and face poor prospects in export markets trying to recover from recession. Some forecasts, typically but not always non-Japanese in origin, have implied an outright decline in Japan's gross national product this year.

Specialists in the Japanese economy, however, generally expect real economic growth of about 2 percent in 1992 and slightly more than that for fiscal 1992, which ends March 31, 1993. Forecasts reflecting December 1991 estimates and revisions through July are shown in Table 1. Even though the estimates have been revised downward in recent months, they still are remarkably optimistic by American standards. A July *Economist* poll of projections from around the world, for example, points to real U.S. and Japanese growth being an identical 2.1 percent in 1992, with the Japanese rate higher in 1993 at 3.4 percent against 3 percent for the United States. In short, despite Japan's present economic difficulties, growth there easily exceeded this country's in 1991 and is projected to match it in 1992 and exceed it again in 1993. If the international forecasters prove correct, the Japanese economy probably also will avoid a U.S.-style recession, defined informally as two consecutive quarters of negative economic growth. The predictions obviously also rule out a full-year decline in economic activity, as occurred in this country in 1991.

Revised Japanese Expectations

If the gloomy outlook of a handful of forecasters regarding the Japanese economy is not likely to be realized, neither are the cheerful expectations advanced by Japanese experts a few months ago. An overwhelming majority of private-sector analysts now strongly reject, for example, the government outlook of 3.5 percent inflation-adjusted growth, a figure adopted last December (see *JEI Report* No. 1B, January 10, 1992). All but one of the business forecasts summarized in Table 1 have been scaled back during the past half year.

However, Table 1 also implies that private-sector projections in Japan, typically for the fiscal year, are considerably higher than the calendar-year predictions made by foreign forecasters. (Organizations such as Nomura Research Institute that develop both calendar- and fiscal-year outlooks do not expect significantly higher figures for the fiscal year.) Inasmuch as at least a few of the private-sector Japanese forecasts should be regarded as deliberately optimistic in order to encourage business, the foreign forecasts on average probably are more on target. However, the latter are not as

Table 1: Summary of Forecasts of Japan's Real GNP Growth in 1992

Fiscal Year Forecasts		
	<u>Previous Forecast</u>	<u>Revised Forecast</u>
Government Outlook	3.5%	n.a.
Research Institute on the National Economy	4.0	3.3%
Daiwa Research Institute	3.1	3.0
Nippon Trust Bank, Ltd.	3.2	2.9
Nippon Credit Bank, Ltd.	2.8	2.8
Fuji Bank, Ltd.	3.0	2.7
Sumitomo Life Insurance Co.	3.1	2.7
Kangyo Kakumaru Research Institute	3.1	2.7
Yasuda Trust & Banking Co., Ltd.	2.9	2.7
Bank of Tokyo, Ltd.	3.2	2.7
Mitsui Trust & Banking Co., Ltd.	3.0	2.6
Japan Center for Economic Research	3.2	2.6
Toyo Trust & Banking Co., Ltd.	2.7	2.5
Tokai Bank, Ltd.	2.8	2.5
Yokohama Bank, Ltd.	3.1	2.4
Mitsui Mutual Life Insurance Co.	3.0	2.4
Industrial Bank of Japan, Ltd.	2.7	2.0
Nomura Research Institute	2.3	2.0
Average of Private Forecasts	3.0	2.6

Calendar Year Forecasts

International Monetary Fund	2.2%
<i>Economist</i> Consensus Forecast*	2.1
Nomura Research Institute	1.9
Organization for Economic Cooperation and Development	1.8
Average**	2.0

Note: For projections on a fiscal year basis the previous forecast typically was made in December 1991, while the revised forecast appeared in June or July.

*Average of forecasts of 20 bank and securities companies in Europe, the United States and Japan. Updated monthly.

**Excludes Nomura Research Institute, which is included in the *Economist* consensus forecast.

Sources: *Nihon Keizai Shimbun*, various issues; the organizations listed; and *The Economist*, July 11, 1991, p. 99.

well-known in Japan. This suggests that Japanese businesses have not fully incorporated the most accurate thinking about the likely direction of the economy.

Other evidence also suggests that the Japanese view of the economy reflects an excessive degree of consensus thinking. A poll conducted early this summer of 70 academic and business economists by *Toyo Keizai Tokei Geppo* magazine found that not one expected the Japanese economy to worsen over the remainder of 1992 from the level of early summer.¹ In the United States, where

economic opinions are said to outnumber economists, such a convergence of views would be next to impossible. Given the surprisingly weak performance of the Japanese economy to date in 1992 and the inherent uncertainty of economic forecasts, a virtual consensus as expressed in the *Toyo Keizai* poll — even if it turns out to be correct — would not appear to be warranted.

While a percentage point or even a few tenths of a point difference in the forecasts of Japanese and foreign economists may seem like a quibble, the gap carries greater significance if placed in historical perspective. As shown in the Figure, the growth of the Japanese economy has fluctuated since 1970, the first year for which consistent year-to-year Japanese data are available. (In the postwar period prior to 1970 growth rates generally were much higher.) However, even bad years generally have been good ones by international standards. For example, among the Group of Seven industrial nations real growth between 1982 and 1991 averaged 2.8 percent. During that time Japan's performance fell below the 10-year, seven-nation average only in 1986 (a 2.6 percent increase), a recession year by the Japanese yardstick.

The only year since 1970 in which Japan experienced a lower rate of expansion than in 1986 was 1974, when the economy actually shrank by 0.8 percent. Both 1974 and 1986 were exceptional years for the economy in other ways. In the first instance Japan was buffeted by the dramatically higher oil prices resulting from the first oil shock. In 1986 the yen was midway through a dramatic appreciation, in which its value would nearly double against the dollar by late 1988. Both these shocks were perceived at the time as external, although some scholars now believe that the macroeconomic difficulties that occurred in 1974 coincided with the first oil shock and were not caused by it. (For details of this argument, see *JEI Report* No. 33A, August 24, 1990.)

In contrast to the earlier periods of sluggish growth, 1992 shapes up as a year in which the slowdown is unquestionably domestic in origin. While the recession in the United States and elsewhere has not helped the Japanese economy, most analysts — Japanese and foreign alike — attribute the most important role in the downturn to the deliberate deflating of the "bubble" economy, a period between 1987 and 1990 in which asset prices rose at rapid rates and perhaps pushed economic growth rates higher. In the consensus view drastic actions by the Bank of Japan to burst the bubble have led to the slowdown in the rate at which gross national product grows.

If foreign forecasts are correct, Japan's economy will be even weaker in 1992 than in 1986. While avoiding the depths of 1974's drop, it will grow more slowly than in 1975, the second year associated with the first oil shock, or in 1973, the year in which the slowdown began. By contrast, if domestic projections are correct, Japan's real economic growth will be above the rates recorded in either 1974 or 1975 and equal to the 1986 figure. Hence, foreign analysts are saying that Japan's 1991-92 homegrown economic downturn will be worse than that caused by any external disturbance — unless the first oil shock is regarded as the cause of the 1973-75 recession. If domestic economists are correct, they could argue that the economy's worst performances likely have resulted from external developments.

If even foreign analysts prove too optimistic, Japan's economy could be in uncharted waters concerning growth. Most foreign experts willing to hazard a guess about 1993 expect that growth will pick up substantially to 3 percent or more. An increase of less than 3 percent in both 1992 and 1993, however, would be a first for any two-year period since at least 1970. As will be argued below, this scenario appears increasingly likely.

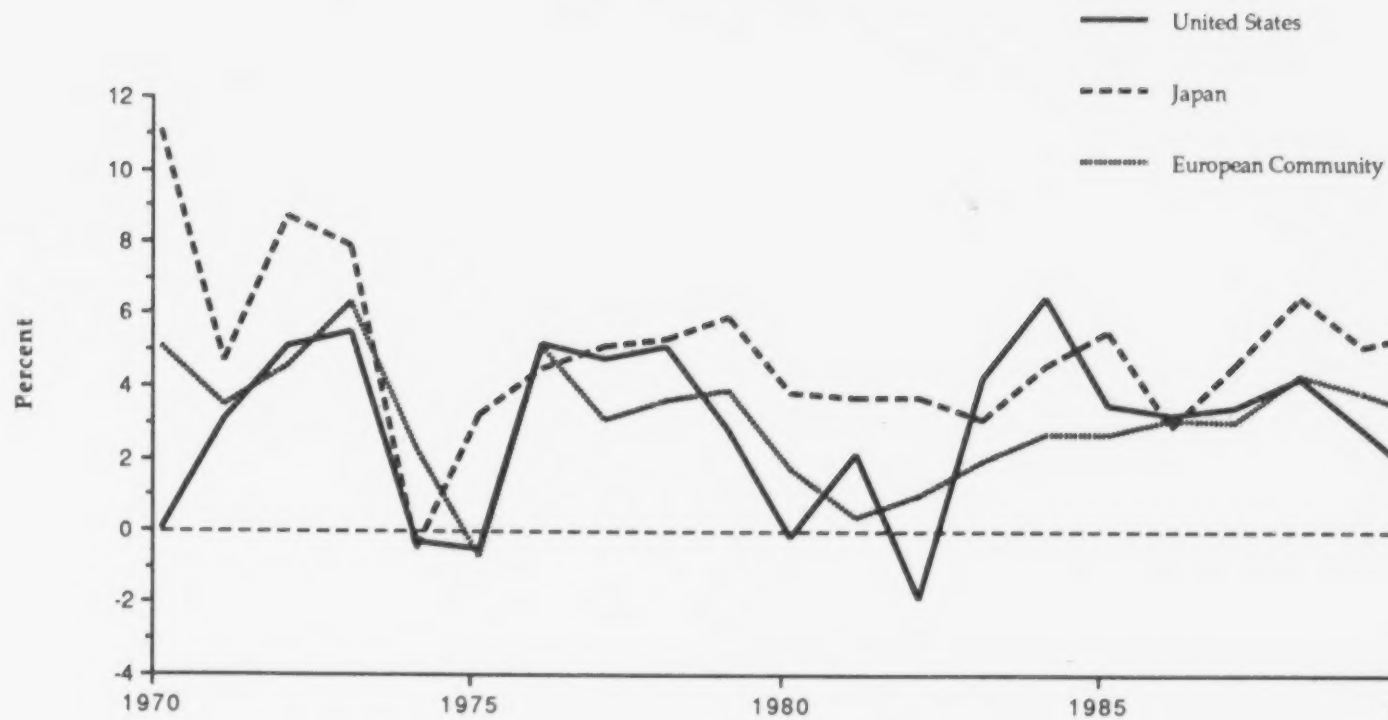
What Caused the Economic Downturn?

Future scenarios depend, in part, on how the economy reached its current state. On this point Japanese economists disagree, with their arguments having a familiar ring to analysts of the U.S. economy.

One group believes that the roots of Japan's downturn are similar to past Japanese slowdowns. Key components in this view are monetary policy and investment behavior. The Bank

International Comparison of Changes in Real GDP, 1970-91

(percent per year)



Source: Economic Planning Agency and Organization for Economic Cooperation and Development

of Japan, by all accounts, slammed the brakes on monetary expansion in 1989, especially after Yasushi Mieno became central bank governor in December. Interest rates, which generally had risen throughout 1989, rose yet again in response. As if sensing that the day of reckoning was at hand, the stock market began its prolonged dive in January 1990, within days of Mr. Mieno's assumption of the top BOJ post. Within a few months the growth of the seasonally adjusted money supply had slowed sharply. As measured by M₂+certificates of deposit, the money supply had expanded at double-digit rates on an annual basis between 1987 and 1989; in 1990 it increased 7.4 percent. By the end of 1991 growth had slowed to only around 2 percent annually.

Tighter money and higher interest rates hurt interest rate-sensitive activities beginning in 1989. The largest such category, plant and equipment spending, was little affected initially, though; business investment continued to expand at double-digit rates in 1989 and 1990 before slowing slightly in 1991, when it reached nearly 20 percent of GNP. Analysts who emphasize monetary policy and plant and equipment outlays stress that the rapid rates of increase in such spending in previous years were unsustainable even if interest rates had remained low; by the end of 1991 many firms had more than enough relatively up-to-date capacity. In short, monetary policy combined with the fall in plant and equipment spending from unsustainable figures have reduced aggregate demand this year substantially below the level indicated by a simple extrapolation of past trends.

An especially severe downturn would result if these factors loom particularly large, this group concludes. By midyear M₂+CDs was growing at less than 1 percent on an annual basis, the lowest rate ever recorded. Similarly, plant and equipment investment could have a long way to fall; capital spending in both 1990 and 1991 generated 19.6 percent of nominal GNP, the highest proportion achieved since 1970 when it hit 21.1 percent. Inasmuch as plant and equipment spending between 1976 and 1986 varied between 13.7 percent and 16.1 percent of nominal GNP, simple arithmetic suggests that a 10 percent drop in business investment, a decrease too small to return the ratio to the upper end of the 1976-86 range, would drag GNP down by nearly 2 percentage points, other factors equal.

Plant and equipment spending, moreover, may have benefited from unusually low capital costs during the bubble period, costs that were not fully reflected in overall interest rates. Large firms were able to float bonds with low-interest yields because the securities carried provisions allowing purchases of equity at a later date at what were expected to be favorable prices. Firms took advantage of this window of opportunity to borrow extensively and stock up on new plant and equipment. New issues of warrant and convertible bonds virtually have stopped as a result of the stock market crash, with one result being that plant and equipment spending could drop substantially among the affected firms.

The alternative view of the economy, which echoes many analyses of the American economy, regards Japan's current slowdown as being qualitatively different from previous downturns. The group espousing this view cites the rise and the collapse of asset prices as the main difference. The Nikkei average of 225 stocks more than tripled between 1985 and 1989 before losing more than 60 percent of its value between the last trading day of 1989, when it stood at an all-time high, and late July, when its value approximated that of mid-1986. Unless the stock market stages a rally of unprecedented proportions during the balance of 1992, the Nikkei will have dropped for three straight years, an event not equaled since the market fell for four years in a row between 1961 and 1965. Data on other assets, such as land, are less precise, but land prices currently appear to be off about 30 percent from their 1989 peaks, at least in Tokyo.

The second group contends that the collapse of equity prices and lower land prices have had a devastating effect on the financial sector; that, in turn, has weakened greatly its capacity to serve as a conduit of economic policy. Japan's biggest banks, for example, may constrain their lending to reach international requirements that bank equity represent 8 percent of assets (generally loans) by

March 31, 1993. As the stock market has sunk, reducing the value of securities that banks may count as equity, the tight lending strategy is rendered more probable. In addition, faced with mounting loan losses, financial institutions of all types are likely to be more selective in their credit policies. Finally, to some extent the stock market collapse has discouraged consumer spending as the wealth of stockholding households has fallen.

What Are the Prospective Solutions?

Monetary Policy - Different opinions concerning the source of the problem imply different solutions. Many experts argue that, to the extent that monetary tightness caused the economy's current sluggishness, monetary ease is the solution. Taking a leaf from the prescription book of Milton Friedman, the American Nobel Prize-winning economist, some Japanese analysts believe that the appropriate policy action is to increase substantially the rate at which the money supply grows. For example, if the economy potentially can expand at about 4 percent per year, the money supply could be increased at approximately that rate each year to generate growth without significant inflation, according to this view.

Opponents of this view take their lessons from Mr. Friedman's intellectual adversaries in this country. They note that in Japan, as in the United States, the relationship of the money supply to GNP is unstable, a condition that suggests that this prescription might not work as predicted. Furthermore, the appropriate monetary measure is open to debate, just as it has been in the United States. The rate of growth of the most commonly used measure, $M_2 + \text{CDs}$, is influenced heavily by shifts among different types of deposits. In recent months the Bank of Japan has been pushing another, more inclusive measure, broad liquidity, which is less influenced by such shifts. The latter yardstick has shown a more stable growth pattern in recent years; in mid-1992, however, it was growing about 4 percent on an annual basis, a rate less than half that of a year earlier. If broad liquidity accurately reflects the rate of monetary expansion, a case could be made that BOJ needs merely to stay its present course.

Other analysts point out that the upheaval in Japan's financial markets has severed the relationships linking central bank action to bank lending policy and borrowers. Even if BOJ eases up, banks may not want to lend, according to this view. Even if they do make loans available, borrowers may be reluctant to take on additional debt, which would reduce the impact of central bank action. Since the relatively slow growth of both $M_2 + \text{CDs}$ and broad liquidity has been accompanied by low interest rates, these analysts suggest that the limited demand for borrowed funds is the major factor in reducing money growth and aggregate demand.

To Mr. Friedman's followers the solution would be a boost in the money supply. They might add that BOJ has focused excessively on interest rates as a guide to the rate of monetary expansion. If weak demand for money — rather than the limited growth in supply — is the cause of declining interest rates, then low interest rates give a misleading indication regarding the rate of growth of $M_2 + \text{CDs}$ or broad liquidity. In short, these analysts argue that BOJ should pay more attention to measures of money and less to interest rates, an argument that some American economists recently have made with respect to Federal Reserve Board policy. Other experts would argue, however, that the combination of low interest rates and sluggish growth of $M_2 + \text{CDs}$ points to the inappropriateness of monetary policy as a viable option in the current situation.

Fiscal Policy - Fortunately for those seeking another solution, fiscal policy appears a reasonable alternative in Japan. Most prescriptions for the U.S. economy have ruled out expansion-generating spending and tax changes on the grounds that the government budget deficits already are too large. In Japan, by contrast, the government has a budgetary surplus, at least when measured on a broad basis. According to data from the Organization for Economic Cooperation and Development, the overall U.S. budget deficit for all levels of government in 1990, the latest year for which comparable data are available, came to 2.5 percent of GDP. Japan's comparable budget

surplus represented 3.1 percent of GNP. (GNP and GDP can be used almost interchangeably in this instance since the two national income concepts are little differentiated within each country.)

Increased government spending or lower taxes would meet real needs in Japan. Even short-term visitors to that nation are struck by the deficiencies in infrastructure, including overcrowded airports and commuter rail systems. Increased government spending could ameliorate some of the crowding. Lower taxes on individuals could promote a shift of national income to households, whose share of GNP has declined in recent years. Fiscal policy is not without its critics, however, particularly among the followers of Mr. Friedman; they regard spending increases and/or tax decreases as being relatively ineffective in expanding the economy and likely to lead to larger government bureaucracies and more pork-barrel projects. In addition, Japanese analysts point out that statistical differences between U.S. and Japanese budget data tend to overstate the apparent contrast in the budget situations in the two countries. Moreover, while the Japanese government recently has run a budget surplus, the accumulated government debt from previous periods of deficit financing still is large.

One effect of increasing government spending and/or reducing taxes is to boost borrowing and the demands on capital markets, thereby raising interest rates. In Japan's case higher interest rates are both good and bad in terms of current policy objectives. They would be good because they would keep Japanese funds at home or attract foreign funds, thereby increasing the demand for yen relative to the supply. The resulting appreciation of the yen would tend over time to reduce Japan's trade surplus, a bone of contention with its trading partners. This argument may well have been behind Washington's advocacy during the 1989-90 Structural Impediments Initiative talks of ¥430 trillion (\$3.2 trillion at ¥135=\$1.00) in investment by Tokyo in public works during the 1990s, a proposal that became part of the SII agreement (see *JEI Report* No. 26B, July 6, 1990). However, higher interest rates also could crowd out plant and equipment spending, which looms as a particularly large portion of GNP in the Japanese case. Some critics, as suggested above, would counter that capital spending is likely to be depressed regardless. Finally, and perhaps most significantly, higher interest rates could exacerbate the already severe problems facing Japanese financial institutions.

On balance Tokyo appears to have decided that the benefits of fiscal stimulus are worth the costs. In April it announced that FY 1992 spending on public works projects would be accelerated, with approximately 75 percent of the funds planned for the fiscal year to be spent during the first half (see *JEI Report* No. 14B, April 10, 1992). In addition, the government has committed itself to a substantial package to be introduced in the fall in the form of a supplemental budget; other initiatives may be announced later this summer. Although no precise figure has been announced yet, press reports suggest that the supplemental budget could be on the order of ¥7 trillion (\$51.9 billion).

The government's 1992 sequence of fiscal policy actions closely follows several previous instances of countercyclical fiscal measures. The timing and the size of those earlier packages appear to have been critical to their effectiveness. For example, in early April 1987 Tokyo announced a speed-up of public works spending and followed up with a substantial supplemental budget that was approved by the Diet in late July (see *JEI Report* No. 15B, April 17, 1987, and No. 29B, July 31, 1987). The result was to avoid a sharp yearend drop-off in public works spending once the effects of the April action to front-load public works spending wore off.

In other instances supplemental budgets have not continued the expansionary effects of a spring acceleration of public works spending. For example, in April 1983 the government announced that public works spending would be front-loaded; that October the Diet passed a stimulus package. After rising sharply in the April-June period, however, public works spending as measured by the GNP statistics declined over the next four quarters despite the October program. In retrospect, the October package, a product of compromise between the Ministry of International Trade and Industry and the Ministry of Finance, appeared to lack much punch.

One lesson of the 1983 and 1987 experiences, the two most recent instances of countercyclical fiscal expansion prior to this year's effort, is that earlier implementation of a stimulus package is more effective than later. A second lesson is that front-loaded public works spending can cause a drag on the economy in the last half of the fiscal year if a supplemental spending package is not big enough. Finally, both episodes demonstrate that fiscal changes have a quick impact on the Japanese economy, apparently in contrast to the United States, where changes in government spending affect economic conditions only after a lag of half a year or more.

Potential Pitfalls and Possible Problems for a Japanese Recovery

Bogged Fiscal or Monetary Policy - The 1983 experience is instructive. If the 1992 stimulus package, which at the end of July was still in the formulation stage, gets bogged down in controversy or emerges in a significantly watered-down form, the economy could experience a temporary drag — rather than a stimulus — from public works spending. The opposite risk of an overly aggressive policy is also present. Some analysts believe that the real cause of the drop in 1974 GNP was an excessively expansive monetary policy in the early 1970s, which had produced double-digit inflation by 1973. The expansive monetary policy of that period appeared to have been based on the assumption that the Japanese economy would continue to grow, as it had during the 1960s, at close to 10 percent per year after inflation. Subsequent events proved that assumption incorrect. As late as 1978, however, government officials were reported to believe that 7 percent annual growth was possible, an assumption that also proved unrealistic.

Today analysts are divided as to the long-range growth potential of the Japanese economy. Nomura Research Institute puts the figure at 4 percent annually during the first half of the 1990s and 3.5 percent during the balance of the decade. Various factors suggest that such figures may be too optimistic inasmuch as they do little more than assume the same growth rates that prevailed during the 10-year period ending in 1991, when real growth averaged 4.3 percent. (For details of the factors that could cause a slowdown, see *JEI Report No. 11A*, March 20, 1992.)

Clearly, if monetary or fiscal policies are adopted with the intention of getting Japan on a 4 percent long-term expansion path at a time when a far slower growth rate is the most that could be expected, the stimulus could prove excessive, with substantial price increases resulting. Subsequent policies to stem inflation could give the economy one or more years of suboptimal growth, even if judged from the perspective of a realistically low potential growth rate.

Given the restraining hand of the Ministry of Finance, the risk of attempting too much stimulus in 1992 appears minimal. Worried about the level of outstanding government debt, MOF has shown a historical reluctance to countenance larger budget deficits. Considering its influence, the greater current risk is a repeat of the experience of 1983, when the supplemental budget failed to fill the gap left by the earlier acceleration of public works spending.

Failure of a Large Japanese Financial Institution² - Japanese officials are fond of saying that no Japanese bank has failed during the postwar period. While technically true, a handful of financial institutions have been absorbed by one or more healthy institutions when they have been on the verge of failing. (This is exactly the same solution typically adopted by U.S. officials to deal with struggling American banks, savings and loan associations, and credit unions. For a recent example of the Japanese experience, see *JEI Report No. 18B*, May 18, 1992.)

To date, none of Japan's largest commercial banks has needed such a rescue. An increasing number of Japanese experts, particularly in the academic community, worry that such an event could occur, however. If one of Japan's 64 regional commercial banks were to fail, for example, Japan's puny deposit insurance fund easily could be wiped out in a single stroke. Given current resources and the climate of caution among more stable institutions, a rescue might prove impossible. In this

situation monetary officials surely would lose their fig leaf concerning Japanese bank failures. Even if a collapse eventually were to be resolved, depositor confidence in Japanese financial institutions could be shaken severely. (Even now, that confidence is not total; reports of shaky loans at some banks have led to widespread deposit withdrawals at the affected institutions.)

A loss of confidence in Japanese financial safety nets, in turn, could affect financial flows, with unpredictable results. No doubt a flight to quality would occur; which institutions or financial instruments would be regarded as secure is not clear. U.S. Treasury securities might look more attractive, for example, because they carry the backing of the U.S. government. However, the Japanese institutions that hold them might appear more risky than before for other reasons, leading to deposit withdrawals and reduced holdings of Treasury securities as the institutions seek liquidity. In this situation inbound capital flows would lead to an appreciation of the yen. Scenarios involving a depreciation of the yen also are imaginable.

If a large bank failure loomed as more than a remote possibility, Bank of Japan and other officials would have far less latitude in developing monetary and fiscal policy responses to the economy's current woes. Fiscal policy measures, for example, would have to be combined with BOJ actions to prevent interest rates from rising. The central bank would be more likely to lower short-term interest rates and risk inflation, if the alternative were bank failures. However, a relatively relaxed monetary policy could prove disastrous to banks in the long run if price increases accelerated, leading to anti-inflation policies that would include extremely high short-term interest rates.

Very Strong Yen - Some of the policies and possible scenarios described above would strengthen the yen. Fiscal stimulation combined with monetary restraint would have this effect, for example. In addition, some analysts have noted that external factors, such as expectations concerning election results in the United States, could drive the yen higher. Inasmuch as the dollar, the yen and other currencies are in the hands of traders who are said to prefer Republican economic policy, the strong prospect of a victory by the Democrat's presidential candidate, Bill Clinton, could send the dollar south before November, implying an appreciation of the Japanese currency. The same currency trends could develop in conjunction with increasing prospects of a victory by Mr. Clinton if traders thought that a Democratic Congress and president would be more likely than divided leadership to reach an agreement to reduce the federal budget deficit; a decreased supply of yen to finance the deficit would increase the value of the Japanese currency.

While not without its benefits, especially in reining in Japan's fast-expanding trade surplus, a higher yen would hurt the profits of Japanese exporters and importers. During the 1985-88 period of yen appreciation many analysts believed that the currency's rising value against the dollar stimulated companies to work harder to reduce costs and improve their products as well as to accept lower profit margins in foreign markets. Indeed, exporters reported that their so-called break-even points, as measured by the yen-dollar exchange rate, improved dramatically; companies that had considered themselves uncompetitive at ¥140=\$1.00 found that they could be profitable even at ¥125=\$1.00. (For details of this argument, see *JEI Report No. 4A*, January 27, 1989.) Profits for exporters, although sometimes dipping in the early stages of the yen's appreciation, had reached high levels again by 1988. Firms, however, had many winds at their backs in this apparently stunning improvement. Foreign economies as well as the Japanese economy continued to grow; by 1987 Japan was booming. Hence, fixed corporate costs could be covered more easily from domestic revenues, allowing firms to reduce margins in foreign markets and still show higher profits.

In short, profitable operations above break-even points depend not only on costs and product quality but also on demand conditions at home and abroad. This argument was brought home earlier this year when the few companies still willing to talk about break-even points admitted a deterioration; one firm, which previously said it was profitable at ¥120=\$1.00, now needed at least ¥130 to the dollar. If the yen were to reach ¥100=\$1.00 within the next 12 months — a not altogether

unlikely possibility given its current value of around ¥125 — and if the economies of Japan and its main trading partners were to remain weak — another less-than-remote possibility, Japanese corporate profits could plummet in the export and import sectors. These businesses already are reporting profits nowhere near the stratospheric levels that prevailed in FY 1990.

Failure of a Large Nonfinancial Concern - In an extreme case a large exporting firm or a company that competes with imports could fail if the yen reached a sufficiently high level and stayed there. Weak home demand or financial overextension could produce a similar result. While Japanese firms are declaring bankruptcy in 1992 at a rate of more than 12,000 per year, all such concerns in recent years have been either relatively small companies, nonmanufacturing firms or both.

During previous downturns even some large manufacturers had severe troubles. In some cases they appear to have been saved by their *keiretsu* links. In the best-known instance of this development Sumitomo *keiretsu* companies helped Mazda Motor Corp. out of severe financial difficulties in 1979.³ However, *keiretsu* ties have become noticeably looser in recent years, as manufacturers have declared their financial independence and developed closer links with companies outside their own group. Mazda, for example, has developed numerous significant financial and product linkages with Ford Motor Co., although it still maintains close ties to Sumitomo companies as well.

Whether *keiretsu* companies would welcome prodigal sons back into the fold should severe financial problems develop is problematic. If not, Tokyo could be forced to develop countermeasures quickly or permit foundering companies to fail. While the skills of Japanese bureaucrats are legendary, developing a consensus on what policy to adopt could take more time than would be available. If a large Japanese manufacturer ended up failing, many assumptions that prevail in both Japan and abroad concerning the inexorable strength of major manufacturing firms would be shattered. Workers, whose perceived job security would decline dramatically, surely would change their behavior in their role as consumers and in bargaining on wages. The event's greatest significance, however, would be as a symbol of the severity of the economic downturn.

Dramatic Drop in Consumer Spending - Such a failure of a nonfinancial firm has to be regarded as remote. One consequence — a drop in consumer sentiment — is somewhat less so, especially considering the likelihood that the full extent of Japan's economic slowdown has not yet been appreciated. Any number of unwelcome events could reduce consumer spending below the levels normally expected during a slump. For example, nonfinancial firms facing business problems could abandon their current policy of hoarding workers for the not-so-distant day when a robust economy confronts a shrinking labor market. A prolonged recession, of course, would make hoarding workers less of an imperative and more of a cost, even for healthy companies. If so, many workers who have felt secure in Japan's still-tight labor market would feel much less so — even if layoffs remain very limited — because of corporate efforts to limit wage increases and other means. The increasingly important, if seldom exercised option, of going to work elsewhere would be a less viable alternative for employees of large companies. In short, a somewhat less tight labor market would be felt even by employees whose own jobs are secure, implying that workers in their role as consumers might cut back expenditures. Many analysts, including Yutaka Kosai, head of the prestigious Japan Center for Economic Research, worry that consumers have reduced their spending as a proportion of disposable income already, lowering the chance that households will play their expected role in leading Japan to an economic recovery.

Welcome Surprises

Not many of these potential pitfalls are likely in themselves. Indeed, the Japanese economy may avoid all of them during the next few years. However, they should be regarded as risks with a nontrivial chance of occurring. Generally, the possibilities discussed so far would increase the probability that real growth in Japan could drop into the 2 percent range or lower and stay there for

more than a year; none seem to carry the possibility of a surprise in the opposite direction. Since few analysts expect a major bank failure, for example, the lack of one would not be a surprise.

Most likely to be welcomed is a surprise involving improved foreign economies. Few economists expect the U.S. economy to boom over the next 18 months, for example, but one cannot be sure. A strong dollar would be another unexpected favorable development for the Japanese economy. If the American currency were to rise as a result of demands for funds to finance an exploding U.S. federal budget deficit, the yen would depreciate and Japanese exporters would benefit. In addition, Japan's Asian trading partners are likely to continue to grow relatively rapidly. Even if the economies of the United States and Europe stagnate, these nations could provide a significant boost to Japanese exports.

One favorable factor would be surprising to American — but not Japanese — analysts. Market signals in Japan appear to work better as macroeconomic stabilizers than they do in other industrial nations. If anything, financial liberalization and deregulation may have enhanced the ability of market forces to respond to weakness in one sector by allocating resources to another. Seventy years ago economists believed that such factors allowed economies to trend toward full-employment; the worldwide Great Depression reduced the ranks of such true believers dramatically. Given Japan's outstanding ability to avoid severe unemployment and U.S.-style recessions in the postwar period, however, factors such as real wage and price flexibility may be effective to some degree in maintaining a high level of aggregate output. Japanese analysts who regularly predict that consumer spending, for example, will pick up the slack left by stagnant exports or weak investment spending seem to be betting that market forces will save the day.

Finally, business investment — whose fluctuations threaten to destabilize the economy — also could buoy it, especially in the long run. Even if plant and equipment spending drops substantially, for example, the stock of such capital will continue to grow. In the 12-month period ending March 31, 1992 the capital stock grew an inflation-adjusted 7.5 percent before depreciation. Even a generous allowance for depreciation implies that the productive capacity of the Japanese economy rose substantially. If plant and equipment spending remains at approximately FY 1991's level in coming years, the capital stock will continue to grow at almost the same rate in the future. A combination of growing demand, higher real labor costs, or increased capital productivity could justify such an expansion. This argument suggests that, if either macroeconomic policy measures or market forces can be marshaled to mobilize this capital to produce output, the Japanese economy could regain its strong growth performance. The next 18 months or so may provide an interesting test of this hypothesis.

Conclusion

Even if allowance is made for such special Japanese factors, the trends now underway suggest that the economic slowdown in Japan is unusually severe — even if that message has not shown up yet in the country's still strong yearly and quarterly GNP figures (see Table 2). In 1991 real GNP grew 4.4 percent against a rise in industrial output of 2.1 percent. Even though GNP was 2.1 percent higher on a price-adjusted preliminary basis in the January-March 1992 quarter than a year earlier, industrial output was down 4.7 percent. In April, May and June industrial output was 6.1 percent, 8.8 percent and 4.2 percent lower, respectively, than in the same three months of 1991. (The June figure is preliminary.) Barring a miraculous turnaround, industrial output is likely to fall for 1992 as a whole for only the fourth time since the index was introduced in 1964.

A comparison of GNP data, which cover all sectors, and industrial output statistics, which emphasize manufacturing, suggests that the nonmanufacturing sector has been far stronger in the last 18 months or so than manufacturing. While this difference may reflect a shift in resources toward nonmanufacturing, past evidence indicates that nonmanufacturing industries can serve only a limited role as buffers for shocks to the manufacturing sector. Industrial output fell 5.1 percent in 1974, 11

Table 2: Japan's Real Gross National Product at Constant (1985) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1990	FY 1991	April-June 1991	July- September 1991	October- December 1991	January- March 1992
Gross Domestic Product	¥406,615.1 (5.7%)	¥420,648.2 (3.5%)	¥418,446.7 (4.0%)	¥420,211.8 (1.7%)	¥420,104.1 (-0.1%)	¥423,649.6 (3.4%)
Gross National Product	409,214.5 (5.5%)	423,565.4 (3.5%)	421,003.9 (2.8%)	423,052.8 (2.0%)	422,715.7 (-0.3%)	427,193.3 (4.3%)
Personal Consumption Spending	234,085.0 (4.0%)	240,619.7 (2.8%)	238,652.2 (6.5%)	240,449.8 (3.0%)	240,692.7 (0.4%)	242,690.2 (3.4%)
Private Residential Construction	22,848.6 (4.9%)	20,261.2 (-11.3%)	21,110.7 (-23.6%)	20,620.8 (-9.0%)	19,621.3 (-18.0%)	19,603.6 (-0.4%)
Private Fixed Nonresidential Investment	88,990.7 (12.1%)	91,683.0 (3.0%)	91,559.7 (-3.0%)	92,225.3 (2.9%)	91,491.3 (-3.1%)	91,440.7 (-0.2%)
Change in Business Inventories	2,901.4 (-20.8%)	3,214.6 (10.8%)	3,172.3 (13.7%)	3,420.9 (35.2%)	3,075.5 (-34.7%)	3,218.1 (19.9%)
Government Current Expenditures	34,428.7 (2.4%)	35,428.7 (2.9%)	35,595.7 (6.5%)	35,114.8 (-5.3%)	35,297.1 (2.1%)	35,691.5 (4.5%)
Government Fixed Investment	26,095.1 (4.4%)	27,579.7 (5.7%)	27,378.4 (20.3%)	27,392.6 (0.2%)	27,655.8 (3.9%)	27,826.1 (2.5%)
Change in Government Inventories	95.1 (*)	-197.4 (*)	-199.8 (*)	240.8 (*)	-942.6 (*)	91.8 (*)
Net External Sector	-230.1 (*)	4,975.9 (*)	3,734.7 (*)	3,587.8 (*)	5,824.6 (*)	6,631.3 (*)
Exports of Goods and Services and Factor Income Received	73,760.4 (7.7%)	77,175.7 (4.6%)	74,796.4 (-8.7%)	76,671.6 (10.4%)	77,949.8 (6.8%)	79,214.6 (6.7%)
Imports of Goods and Services and Factor Income Paid	73,990.6 (7.2%)	72,199.8 (-2.4%)	71,061.7 (-7.9%)	73,083.8 (11.9%)	72,125.2 (-5.1%)	72,583.3 (2.6%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

percent in 1975 and 0.2 percent in 1986. As noted earlier, 1974 and 1986 were the two years in which overall economic growth was the slowest. The simple, if far from exact, relationship of industrial output to GNP growth in the past points to subnormal aggregate growth at least for 1992. The fact that preliminary data showed that inventories still were growing in June suggests that production cutbacks probably have not run their course and easily could continue well into 1993.

These arguments imply that the Japanese economy will be lucky to expand in the widely forecast 2 percent range this year and may not grow much faster next year. Furthermore, the potential exists for severe shocks that could reduce real growth still further; the upside potential appears minimal. As noted earlier, even if no major hitches develop, the Japanese consumer is likely to be surprised at the rough ride. American analysts may well conclude, though, that the Japanese economy has ridden out yet another violent storm while barely getting wet.

For further information, contact Douglas Ostrom.

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Notes

¹"Ekonomisto Shichijunin-ni Kikimashita," *Toyo Keizai Tokkei Geppo*, August 1992, pp. 12-15.

²I am indebted to Thomas F. Cargill of the University of Nevada at Reno for this example.

³For details of the Mazda rescue, see Richard Pascale and Thomas Rohlen, "The Mazda Turnaround," *Journal of Japanese Studies*, Summer 1983, pp. 219-263. For information about *keiretsu* generally, see *JEI Report* No. 2A, January 12, 1990.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.